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Rehabilitating Internal Controls*

BY DONALD P. PERRY

The significant interests of comptrollers and certified public accountants lie identically in the field of financial accounting, but the points of view of the corporate officer and of the independent examiner are enough different that joint consideration of problems in that field may be particularly illuminating. So, in the matter of internal accounting control, the purposes of our two groups are essentially the same—devising, improving and appraising practical methods which will provide adequate safeguards and enhance the accuracy of accounts and reports drawn from the accounts. The comptroller brings to bear especially his intimate knowledge of the organization and operations of the business in question, while the professional auditor draws from his experience with diverse types of companies.

It seems useful to consider at this time a diagnosis of the present general state of health of internal accounting controls. I suspect that we may find them somewhat run down, if not debilitated as a result of wartime wear and tear and lack of tonic, vitamins and refreshment. In many cases they need more attention than has been possible in several years from their family physicians, the comptroller and internal auditor, and also from the certified public accountant as consultant.

*This article was the subject of a talk by Mr. Perry before the Boston Control of The Controllers' Institute of America, and appeared in the December, 1945, issue of *The Controller*.

WARTIME NEGLECT

Consider first the many strains and types of neglect to which internal accounting control has been subject during the war years. Under any circumstances continuous vigilance is required to see that a plan of internal check is rigorously followed. It has often been pointed out that the best planned accounting routines will not fulfill their purposes if employees do not scrupulously carry out the methods prescribed or if they are not watchfully supervised. Adequate supervision has been well-nigh impossible under wartime pressure and under the manpower conditions which have existed not only have the numbers of clerical employees been insufficient to operate our accounting routines efficiently, but the quality of personnel has been sub-

standard. Clerical errors have increased, initial recording of transactions has often been incompetent and such errors are compounded where the usual cross checks could not be maintained. The whole situation has tended to relaxation of efficient, scrupulous following of routines. A careful process of tuning up and tightening up controls is now required.

Furthermore, wartime pressure has forced many companies to modify their internal controls because of fundamental changes in operating functions or to omit altogether some desirable accounting procedures because of insufficient clerical help. Not infrequently has the pressure of the armed forces for procurement of materials been so great that industries have been forbidden to halt production for the purpose of inventory taking and several years may have elapsed without opportunity to check the accuracy of book inventories by a physical count of stock on hand. In other cases cost systems have been jettisoned in part or in whole because the management could dispense with the information in the absence of competitive conditions and may have felt that renegotiation of prices with the big single customer made determination of unit production costs of little significance in setting selling prices. Cost-plus-fixed-fee contracts and the more or less subtle influence of renegotiation and high taxes, together with a constant sellers market, must have tended to relax the procedures ordinarily set up to ensure efficient purchasing and to keep expenses within bounds, as well as methods of checking the utilization of raw materials, parts and stores.

Even in the field of cash safeguards, it has recently come to my attention that during the war most of the large commercial banks have abandoned their former practice of examining endorsements of checks returned and paid through the clearing association. If, due to similar wartime pressures the bank's customer also omitted the procedure of scanning canceled checks for the payees' endorsements, a significant safeguard over the integrity of the cash payments would have been totally absent.

It is probable that maintenance of detailed plant records of acquisitions, removals and depreciation may have been neglected during the emergency period and that with the U. S. Government the chief customer, the practice of verifying accounts receivable by sending periodic statements or internal auditors' confirmations may have been considerably curtailed. Plans previously in effect for rotating assignments and for providing regular vacations for clerical employees must have been abandoned in the face of essential work to be done, although such plans for shifting responsibilities may have been in-

tegral features of the system of internal check. It has often been necessary to consolidate duties and thereby sacrifice safeguards resulting from segregating functions and from clear-cut accountability for a definite segment of work. Accounting routines prepared in haste for enormously increased volume of business or for a new field of enterprise may have been poorly designed from the viewpoint of the best internal check. The responsibility for designing procedures and systematizing records has frequently fallen on supervisors overworked or without adequate experience for such duties. The most appropriate mechanical aids for automatic control have often not been available because of restrictions on the production and distribution of bookkeeping and calculating machines, checkwriters, postal meters and the like. Manuals of procedures and organization charts have been rapidly obsolescent and there has been little opportunity to revamp them and keep them up to date.

Diversion of Personnel to Other Duties

In many cases personnel once employed on functions of internal control have been diverted to other duties. Those verifying payrolls, for instance, may have been assigned to payroll preparation with some inadequate substitution for the verification work. This situation has been common with internal auditing departments. Most internal auditors and their staffs have had their usual duties forced into the background or eliminated by work on special assignments, usually arising from the myriad of wartime regulations. They have been investigating wage and salary stabilization compliance, setting up methods of assembling Price Administration reports, working on termination claims or preparing data for renegotiation. Their regular programs of check have fallen into desuetude and it may have been years since the internal auditor has been able to make routine examinations and reports in line with plan.

Five years ago the subject of internal accounting control seemed to be on the verge of substantial development. The Controllers Institute, cost accountants, accounting instructors, certified public accountants and even the S.E.C. had completed preliminary discussions and analyses of the functions, purposes and general methods of internal check, including its place in the independent audit of financial statements. If the problems of the war emergency had not intervened, there was every expectation that this recent period would have shown a great deal of hard, concrete thinking accomplished on the subject and substantial advance by almost every business concern in the application of principles which were

being widely discussed and disseminated. While it is true that many concerns have made great progress in developing their internal methods of control, nevertheless this field might have been much more intensively cultivated and to a considerable extent the soil has deteriorated and become eroded by the emergency pressure which the war has placed upon industrial organizations.

Suspended Development

The difficulties of practice in wartime have had their effects in retarding development of the public accountants' function of reviewing the methods of internal check followed by their clientele. The accounting profession has had a lively appreciation that its reliance on systems of internal check has been especially critical under wartime conditions and business volume and that weaknesses might be expected more readily to develop in these times. Nevertheless, shortages of experienced staff personnel, the pressure of special engagements and the rapidly shifting operations and organizations of clients have probably tended to delay improvements which the auditing profession has aimed to make in this phase of practice. For example, while it is generally recognized that this part of an annual examination is most advantageously conducted in advance of the year-end so that it may be integrated with the whole audit program and possibly result in modifying that program, during the war review of the system has occasionally had to be postponed until after other features of verification were completed. Available time has afforded little opportunity to appraise, revise and improve the methods and programs used for reviewing the effectiveness of clients' routines. Programs, questionnaires, check lists or memorandum instructions have tended to remain unrevised during the war years. The profession should now make up for lost time by bringing this part of its work to a higher level of performance.

Such is the diagnosis of the state of health of internal accounting control as the war period comes to an end. What types of treatment should be prescribed by Doctors Comptroller and Certified Public Accountant?

Toning up Morale

At the head of the list of treatments comes the toning up of morale. An attitude of respect for rigid adherence to sound principles of internal check should be cultivated throughout the business organization from top executives down. It has already been suggested that laxity in following prescribed routines may have been a frequent result of the strains and stresses of encompassing the wartime volume of work and the difficulties of providing adequate supervision and

review. Laxity has by no means been confined to the field of accounting. Our poorly laundered linen, the uncooperative sales service in our retail stores, the catch-as-catch-can repair work on our overworked automobiles are all evidence of the deterioration of standards of service which inevitably has occurred in the attitudes of employees during these years, when there has been more than enough work for every worker and we were ready to beg, bribe or hogtie them to stick to their assignments. Such attitudes toward quality of work and service must be purged from our business life and the therapy of retraining will be long and hard both for reeducators and for trainees.

Rigorous Following of Routines

At the heart of effective internal check is the rigid following of prescribed routines. Some executives are indifferent to the importance of having a rigorous system of bookkeeping maintained at all times. They may not realize that large embezzlements have had their inception usually in small peculations easily made possible because the management had put up with slipshod methods of bookeeping. The careful routing of all transactions under a prescribed system which provides for the checking of one clerical operation by another impresses some men in executive positions as cumbersome or unduly expensive. A system of internal control is not adequate if in practice the management permits frequent deviations from prescribed procedures. The executive who cuts across routines to expedite a transaction in which he is interested is not truly contributing to efficient handling of business.

A particularly embarrassing series of defalcations discovered during the past year were perpetrated by a so-called trouble-shooter who specialized in such matters as expediting payments to vendors and creditors whose invoices had been delayed in the routine handling because of special problems involved in the transactions. He had been allowed to cut through the normal procedures and to bring invoices or requests for expense advances directly to the cashier for instant payment. Consequently the routine safeguards were not effective as to these payments and the trouble-shooter soon found frequent opportunities based on duplicate invoices or fraudulent vouchers to obtain checks which he was able to negotiate for his own benefit. This occurrence was in a large and critical war enterprise where expedition was frequently essential. The solution, of course, should have been either to revise the routine procedures to prevent bogging down of problem items or to have required the trouble-shooter to do his expediting, after he had found the items,

by shepherding them quickly through the normal course of handling prescribed. Even when the sums are not large, it may be imprudent to permit any departure from the usual routine, if only because such exceptions only tend to grow in number and because they set poor examples to members of the organization who are expected constantly to follow the prescribed procedures.

The better managed concerns follow the policy of maintaining an adequate staff and organizing their methods so that there is a reasonable current check upon the accuracy of the daily work. This policy is worth its expense and obviates a complete or detailed audit by public accountants or internal audit staffs. The expense of a detailed examination into cash transactions through the year is not justified when the auditor is satisfied, as a result of inquiry into methods and his audit of a few transactions by way of test, that well developed procedures for the handling of funds and bookkeeping for cash are in force.

Responsibility of Each Employee

So all members of our organizations should be firmly impressed with the seriousness of their duties in connection with the system of internal control. The officer authorized to sign checks must avoid being a mechanical penman and have regard to his responsibility for seeing that supporting documents are actually in order and, if they are not, for investigating and reporting the nature of the weakness revealed. It is still not infrequent that checks are signed in blank in advance and that no routine procedure is in effect for canceling vouchers when paid. Such weaknesses would not exist, if the executives responsible for making payments understood the practical value of rigid adherence to sound standardized procedures.

Manuals of Procedures

The usual tool for implementing the system of internal control is a manual of procedures. Well organized manuals kept up to date are essential for a concern of any size and complexity of operation. Isolated memoranda not clearly integrated into the general plan are inadequate substitutes for a manual. The written manual of procedures forces the accounting executive to formulate a rational, coordinated and practical plan and it definitely records the responsibilities of all members of the organization in a way they cannot easily evade. Furthermore, detailed written instructions as to procedures are invaluable in periods like the present when personnel changes so rapidly at all levels that methods recorded only on the tablets of memory will not be transmitted accurately, if at all, to successive occupants of a position.

If development of a concern's internal procedures has been neglected during wartime, the manuals of prescribed routines have surely become obsolescent and in need of partial or general overhaul. Such a task could well provide opportunity for reeducation of staff in their responsibilities for following standard practices and in the company's policy of expecting efficient adherence thereto. Revamping the manuals will require the accounting executives not only to reappraise plans of the past and develop a more rational and perhaps more modern system, but also to gain considerable insight into the attitude of the whole organization toward internal control and into the extent that actual practice has been following the procedures prescribed in the past. What to a clerical employee is apparently a time-saving short-cut may represent elimination of a valuable cross check which that employee is in no position to recognize. The accounting executive who issues manuals of procedure and bulletins of instruction is by no means thereby assured that those procedures will continue to be followed unless periodic steps are taken to investigate and check on the fact either by direct observation or through the programs regularly carried out by an internal auditing department. Of course, public accountants also review the methods of internal check and should be satisfied that they are being effectively practiced as evidence of the reliability of the accounts being examined. Yet the accounting executive may not properly rely solely on such review by the outside auditors to see that the system for which he is responsible is in fact working effectively as planned. Continuous vigilance in this field is necessary on the part of the comptroller, group supervisors, internal auditors and public accountants or the routines may break down and intended safeguards disintegrate without those responsible being the wiser.

Recognizing Changes in the Business

In making a comprehensive review of the methods of internal control of a business with the purpose of revising them in the light of present needs and up-to-date standards, we should give ample consideration to changes in the business which may have taken place during the war years or which may be contemplated by the management in connection with reconversion to post-war operations. The volume of operations may have permanently increased. Certainly many concerns which were doing a relatively small business before the war have, under the stimulus of wartime orders, found themselves able to multiply their production and will not be content without a struggle to be relegated again to the minor leagues. Such concerns may now be

in need of organized internal auditing methods which were not feasible in earlier years. The size of fidelity bonds may need review and adjustment upward in some cases; or downward, if the level of liquid assets is permanently lowered. Payroll records and procedures are fruitful subjects for review in the light of prospective employment levels. The change from doing business primarily with the government as the big customer to a highly competitive situation with many customers should lead to a scrutiny of the controls over sales, accounts receivable, credits and collections. In many cases procedures in this area will need fundamental overhauling. Cost systems which have been operated previously with a view to determining actual costs under war contracts will be revised to provide control over costs and expenses, information as to variations at different volumes of production and aids to setting optimum selling prices. Changes in product and requirements for greater investment in stocks of parts or finished goods will call for improved methods of inventory control.

Principles and Fundamental Methods

It is beyond my purpose to set forth a detailed system of internal check. There is a respectable body of literature on the subject, mostly prewar writings plus incidental articles of more recent vintage. The subject is implicit in the fields of constructive financial and cost accounting, in budgeting, in office management and in business organization. I doubt if a definitive work has yet been written nor if sufficient theoretical analysis and exploration of its principles has been made. The practical aspects of internal check will certainly tend to change as methods of business administration and mechanical aids to accounting evolve and improve. It may be helpful, however, to discuss and remind ourselves of certain of the principles and fundamental methods.

First it should be emphasized that internal control is not to be considered as confined to detailed accuracy of records nor to guarding against minor fraud and manipulation. Many of us have held this restricted point of view, because the subject came to the forefront at a time when professional accountants felt a need of educating the public as to the aims and limitations of the usual financial audit. When it was explained that business organizations had become so large that detailed audits of all records and transactions in the traditional manner were no longer economically feasible nor essential to reaching opinions regarding the financial statements, business management asked what assurance is there that peculation, embezzlement or other irregularities have not taken place, if the auditors merely report on the

closing financial position and over all results of operations. The answer was that protection against these dangers was to be found primarily in the system of internal check. The result has been that such protection has often been regarded as the sole function of internal control.

We should look upon internal control in the broader sense of providing safeguards over the fundamental accuracy of the records, the correct classification of transactions, the fairness of financial summaries and even the carrying out of business policies as determined by the management. The basic organizational divisions of the whole enterprise should be utilized to provide cross checks on the performance of operating departments. Skillfully conceived operating reports, the setting of standards and budgetary control may all be considered parts of the system of internal control. Accounting procedures should provide adequate and timely check on operational performance as well as on the integrity of the detailed records. Executive reports and comparisons with standards and budgets may be used in judging the efficiency of labor, the reasonableness of investments in inventory and in plant additions and the effectiveness of credit and collection methods. Therefore, the comptroller and the public accountant concerned with devising or reviewing the internal controls should have comprehensive familiarity with the organization chart, the responsibilities of all officers and executives, as well as the materials, processes, products, properties and policies.

Examples of Fundamental Principles

While no two systems of internal check will operate alike and each must be tailor-made to fit the size, operations and organization of the company, the fundamental methods fall within a relatively small group of principles among which I would list the following:

1. *Cross checks arising from division of responsibility and separation of functions*
2. *Defined accountability, i.e., the fixing of responsibilities for certain assets in one individual or group*
3. *Publicity and attendant fear of discovery*
4. *Mechanical devices*
5. *Protective measures for safeguarding assets*
6. *Rigorous routines as to methods and record keeping*
7. *Reports which provide comparisons with standards*
8. *Internal auditing procedures*

Use of Cross Checks

The first principle I have listed above, the use of cross checks, refers not only to available proofs arising from passing the processing of a transaction along through successive hands but also routine provisions for checking calculations, for obtaining written approvals of

supervisory employees and for separation of responsibility for record keeping from that of custody. Many examples will be found throughout the field of accounting procedures such as:

(1) *divorcing the cashier from opening mail, making bank deposits and bank reconciliations, customers' ledgers and other accounting records;*

(2) *having checks signed by employees with no access to cash receipts;*

(3) *having disputed items, adjustments and write-offs of accounts receivable handled by someone other than the accounts receivable bookkeeper;*

(4) *giving those keeping security records no access to securities;*

(5) *requiring formal authorizations for capital expenditures;*

(6) *separating sales analysis from the accounting department;*

(7) *segregating the purchasing department from accounting, receiving and shipping functions;*

(8) *rotating duties of those preparing payrolls and double checking clerical operations in payroll preparation;*

(9) *segregating approval of pay rates, maintenance of accounting records and the paying off functions from payroll preparation;*

(10) *complete divorce of the accounting department from sales, manufacturing, purchasing, cash receipts and disbursements;*

(11) *provisions for general rotation of duties and for vacations to be taken by all employees.*

This general principle of segregation of responsibility is one of widest application and should be utilized to the utmost. Even in small concerns or in branches, it can be adapted to considerable advantage and without excessive cost by skillful division of duties among a small group of employees. Prescribed checking of clerical work by another employee will often prove effective where there is insufficient volume to permit segregating the successive steps in handling a transaction. The manager of a small office may personally review the payroll regularly and compare the accounts receivable with monthly statements while watching collections and, by thus keeping intimate touch with the details of the business, feel that he is exercising an excellent form of internal control.

Defined Accountability

Defined accountability is also a widely applicable principle in developing internal control. The imprest system for petty cash and working funds, centering custody functions in the cashier or making the treasurer responsible for physical control of negotiable securities and notes, defining the duties of the plant engineer, employment of a transfer agent and the installation of tight storeroom arrangements and procedures for responsible care of materials, small tools and other inventory items may all be classed as coming under this feature of ac-

countability clearly defined and centered in individuals. Customary controls over sales of admission tickets, sales by delivery men and in chain store accounting methods are also long established applications of the accountability principle.

Publicity and Mechanical Aids

Publicity and fear of exposure are preventatives of dishonesty afforded by the practice of giving receipts to customers and the use of cash registers, fare boxes and similar devices. Other mechanical methods are availed of in internal control. Among these may be mentioned the prenumbering of checks, receipts and vouchers, shipping advices, receiving tickets and purchase orders; check-writing machines and protectographs, bookkeeping machines which do mechanical posting and prepare multiuse copies of accounting forms; postage meters; and tabulating machines, which may provide analyses and summary reports available for prompt comparison with other records.

Protection of Assets

Methods of protecting assets from theft or other loss are also features in a general plan of internal control. The bonding of officers and responsible employees, the use of safe deposit vaults, cashiers' cages, office safes and storage facilities for goods; employment of express services for transport of currency and for payroll distribution, restricting the size of cash funds to the minimums required and diversifying general cash over a group of depository banks are all protective measures used by careful business men.

Adherence to Prescribed Routines

The importance of strict adherence to accounting routines has already been stressed. The policy of prescribing and permitting no deviation from detailed methods of handling records is in itself an essential feature of control. Illustrations of requirements which should be scrupulously followed are:

(1) *formal vouchers for all disbursements typed or written in ink;*

(2) *the drawing of all checks to the order of a person (rather than to cash or petty cash);*

(3) *the recording of all types of sales (e.g., to employees, of equipment or scrap, for cash or C.O.D.) under the same protective routines as used for charge sales to customers;*

(4) *definite rules for checking all invoices payable against purchase orders, receiving reports and inspection reports and as to prices, extensions and freight charges;*

(5) *rules for making all payments by check and*

(6) *the dealing with special payroll items under the same general plan as the regular payroll.*

Reports

Reports to the operating management should be adequate to bring to light abnormal financial figures and other discrepancies. They should set forth and explain variances between operating costs for successive periods and in comparison with budgeted and standard amounts. The system of reports throughout the company organization frequently needs review and revision to keep them of maximum effectivenes and to see that they are in fact being used by both major and minor executives as a basis of exercising practical controls over operations and accuracy.

Internal Auditing

The last feature of internal control listed above was the internal audit department. There has been considerable expansion of this function in recent years, as evidenced by organization of the Institute of Internal Auditors and a growing literature. Employment of internal auditors is by no means confined to larger business enterprises. Many medium sized concerns have found it advantageous to create and fill this position. The functions and duties of the internal auditor merit considerable thought, and planning, taking into account both the accounting and control methods of the concern and the part played by the outside independent auditors. The internal auditor's duties should therefore be rather definitely prescribed in carefully evolved written programs which will provide for his covering a wide field of examination over stated periods. The program of internal audit is profitably subject to review and comment by the public accountant so that the work of the two may dovetail. The internal auditor's written reports, with his working papers, should be made available to the public accountant as additional evidence of the integrity of the accounting records. An important duty of the internal auditor is to review and report upon the practical functioning of all prescribed routines and procedures which comprise other features of internal check. His methods of review will generally be similar to those followed by public accountants in examining and passing upon the effectiveness of the system of internal control. The internal auditor, however, has a more direct responsibility to the management and his examinations may properly be expected to be more intensive and frequent.

Responsibilities of the Public Accountant

The public accounting profession by now should be well instructed in its responsibilities for review of the systems of internal check of its clients and the purpose of such reviews in connection with periodic audits. The bulletins of the American Institute of Accountants Committee on Auditing Procedure and

many articles by members of the profession have discussed these matters.

What we should now concern ourselves with primarily in the profession is improvement and dissemination of our technical knowledge in this field—first, as to the principles of internal control and their application in detail to the organization and procedures of business and, secondly, as to our methods as auditors in reviewing and appraising potential reliance on the internal control measures used by clients. Both of these technical aspects of the subject can doubtless be developed extensively in group discussions within our firms, within our professional societies and, in such meetings as this, jointly with other accounting groups. The result should be an expanding body of knowledge tending to clarify the subject both for students and for members of the profession. A number of the principles of internal check and examples of their specific application have already been reviewed. Such matters might well be subjects for forum meetings, discussion groups or question and answer periods.

In the second category of technical subjects are those relating to auditing procedure, of which a few questions may be briefly mentioned.

Written Staff Instructions

What is the best form of providing written staff instructions for the auditor's review of internal check? In some cases the procedures for such review are incorporated in the regular detailed audit program. In other cases reliance is had on general bulletins setting forth policies and instructions, often supplemented by miscellaneous staff memoranda. Like the accounting manuals of many business concerns it is probable that accounting firms relying on staff memoranda issued from time to time will desire to make revision and integration of such memoranda one of their early postwar projects. Some firms have developed reminder lists of points to be considered in reviewing the methods of internal check, while others have compiled comprehensive questionnaires, which when completed become a part of the working papers on each engagement.

There are a number of advantages to the comprehensive questionnaire, particularly with auditing organizations of some size. The questionnaires provide in summarized form certain concrete evidence that a rather complete survey has been made, which may be conveniently used by the supervisor reviewing the case. The items in the questionnaires are classified in such a way that they may readily be used in conjunction with verification of the several elements of the financial statements. The danger of the questionnaire, of course, is that it be relied upon to an extent that imaginative judgment of the suita-

bility of procedures to particular situations will not be encouraged.

The better and more experienced the auditor, the less reliance he will need to place on rigid questionnaires and reminder lists. As a practical matter, however, the well conceived questionnaire would seem to provide the most sound and reliable form of written instructions for this aspect of auditing.

Integrating the Review with Account Verification

Another field for practical discussion covers such questions as when during the course of an audit the review of internal check should best be made; how to integrate the review with the various verification steps in the audit; how many sample cases should be investigated and to what degree of intensiveness; what are the advantageous possibilities of varying emphasis from year to year in recurring audits. If review of internal check is made toward the end of the examination, one loses the advantage of fitting the program of verification to the client's accounting methods as disclosed by the review of those methods. On the other hand, completing a program of methods review before beginning any of the steps of account verification may not be efficient. Exchange of experiences and discussion of concrete situations may substantially improve our techniques in this regard. It is generally agreed that intensive study of procedures used in handling individual transactions is the best means of judging whether prescribed procedures are actually being followed in practice and whether they are adequate. We are left with the problem, however, of how many such concrete cases would represent a fair testing of the effectiveness of the internal control.

Cooperation with Corporate Accounting Officers

The means by which the certified public accountant may cooperate with the comptroller and internal auditor is another field to be further explored, particularly in view of the increased number and expanded scope of internal auditing departments. Certainly the certified public accountant should make effective use of the results of the internal auditor's work. The extent to which that work should be reviewed, the form in which its results should be presented as evidence and the limitations of those results as independent evidence should all be studied.

The Period of Reconversion

In looking forward to postwar practices of auditing, there should now be time and incentive for devoting more effort to reaching answers to these questions, to improving our techniques and to instruction of staff accountants.

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Income Tax Aspects of Stock Options

By W. H. Davidson
(New York Office)

On April 12, 1946 the Treasury amended its regulations and issued a new ruling regarding the income tax consequences of the granting to an employee of an option to purchase stock of the employer corporation, or of an affiliate of the employer corporation. These releases contain some very bad medicine and some very good medicine, according to whether the options were granted before or after February 25, 1945. Some discussion of the background of this subject is necessary for an understanding of the significance of the new rulings.

History

For many years the tax situation regarding stock options has been quite confused. The Treasury regulations prior to the recent amendment provided that:

> If property is transferred by . . . an employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such . . . employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value *to the extent that such difference is in the nature of . . . compensation for services rendered or to be rendered. . . .* (Sec. 29.22(a)-1, Reg. 111. Italics supplied.)

The determination of whether in any particular case the difference is in the nature of compensation is obviously not the most simple problem and courts reached varying results. As the Board of Tax Appeals said in one of its opinions on this subject:[1]

> Numerous cases which resemble the instant case in many respects have been decided and the results in many of them cannot be reconciled as to conclusions of fact or conclusions of law.

However, the trend of the cases was definitely to the effect that if the option price was not substantially less than the fair market value of the stock at the time the option was granted the employee realized no taxable income when the option was exercised even though the stock appreciated substantially in the interval, if the evidence did not indicate an intention to compensate the employee.

The Smith Case

Then, on February 26, 1945, the U. S. Supreme Court decided the famous *Smith*[2] case. This case really established no new principle but rightly or wrongly it added considerably to the confusion. The *Smith* case originated in the Tax Court.[3] The taxpayer for many

[1] *Geeseman*, 38 BTA 258.
[2] 324 U. S. 177.
[3] T. C. Memo Feb. 26, 1943.

years was employed by the Western Cooperage Company. In 1934 Western took over the management of the Hawley Pulp and Paper Co. pursuant to a plan for its reorganization. Hawley was then in financial difficulties, with an indebtedness amounting to $2,790,150. Under its contract with Hawley, Western was to retire annually a certain amount of Hawley's indebtedness. In the event of success in this undertaking, and when the amount of Hawley's indebtedness had been reduced by the sum of $1,400,000, Western was to receive specified amounts of the Hawley Company's capital stock as compensation for the services thus rendered.

The taxpayer was active in the reorganization of the Hawley Company. In December, 1934 the president of Western gave the taxpayer an oral option (as a reward for services rendered by the taxpayer prior to December 10, 1934) to purchase part of the Hawley stock, to be acquired by Western under its contract. The Directors of Western on May 4, 1937 authorized the delivery of a formal written option, dated as of December 10, 1934 to purchase at 10 cents a share a specified proportion of the Hawley stock, the terms being the same as the oral option. The written option specifically stated that it was:

> . . . in consideration of services rendered by John H. Smith . . . prior to the date hereof, in negotiating the plan of reorganization . . . and in bringing about the deposit of securities enabling the confirmation of said plan. . . .

In March, 1938 the taxpayer exercised his option and paid Western 10 cents a share. Part of the shares were delivered to the taxpayer in 1938 and part in 1939, the delivery being made a day or two after Western received each block from Hawley, as the indebtedness of Hawley was reduced. On December 10, 1934 the common stock of Hawley had a market value of not more than ten cents a share. The stock of Hawley appreciated substantially in value between December 10, 1934 and March, 1938 when the option was exercised and appreciated further between the latter date and 1939 when part of the stock was delivered.

The Tax Court sustained the Treasury and held that the difference between the option price and the fair market value of the stock when received by the taxpayer was taxable compensation for personal services. On appeal, the Circuit Court of Appeals for the Ninth Circuit[4] reversed the Tax Court and held that though the option was granted as compensation for services, the option was not stock or the equivalent of stock and since the stock was acquired by purchase the taxpayer derived no taxable income from the transaction. The case then went to the U. S. Supreme Court.[5]

[4] 142 F. (2d) 818.
[5] 324 U. S. 177.

The Supreme Court reversed the Circuit Court and sustained the Tax Court and the Treasury. The Supreme Court said that when the option price is less than the market price of the property the option may have present value and may be found to be itself compensation for services rendered but that since this option had no market value when given it could not itself operate to compensate the taxpayer. It could do so only as it might be the means of securing the transfer of the stock from the employer to the employee at a price less than its market value, or possibly, which the Court did not decide, as the option might be sold when that disparity in value existed. The Court said:

> Hence the compensation for respondent's services, which the parties contemplated, plainly was not confined to the mere delivery to respondent of an option of no present value, but included the compensation obtainable by the exercise of the option given for that purpose. It of course does not follow that in other circumstances not here present the option itself, rather than the proceeds of its exercise, could not be found to be the only intended compensation.

Upon rehearing[6], the taxpayer contended for the first time that if he was taxable at all after the receipt of the option in 1934, he was taxable as of March, 1938 when he exercised his option and therefore was not taxable on the appreciation in value between March, 1938 and 1939 when a substantial part of the stock was delivered to him.

[6]324 U. S. 695.

He was overruled in this contention on the ground that he did not have an unconditional right to receive the stock when he exercised his option in March, 1938, since there were conditions on the right of Western to receive the stock from Hawley.

The one important fact in the *Smith* case is that the taxpayer *conceded* that as stated expressly in the written option, it was granted in consideration of services rendered. The Court merely held that assuming it was intended to compensate the taxpayer, the taxpayer received his compensation when he received the stock, since the option itself had no value when granted. Furthermore, the Supreme Court merely upheld the Tax Court which in earlier cases had overruled the Commissioner where the evidence did not disclose an intention to compensate the employee.[7]

POST-SMITH

There is nothing whatever in the *Smith* decision to indicate that in every case an employee is taxable when the fair market value of the stock at the date of purchase exceeds the option price. The Tax Court has recognized this as recently as January 31, 1946 in the case of *Lamond*[8] in which it followed its own decisions rendered prior to the *Smith* decision.

[7]Geeseman (supra); Springford, 41 B.T.A. 1001.

[8]T. C. Memo.

In the *Lamond* case, upon organization of a corporation the taxpayer was given an option to purchase up to 25 per cent of the capital stock at $100 per share as an inducement to become an officer of the company. Part of the option was exercised many years later when the stock was worth $200 per share. The Tax Court found as a fact that the option was not given as compensation, and held that the taxpayer derived no taxable income from its exercise. The Court said:

> Whether the difference between the fair market value of the shares which petitioner purchased in 1941 and their cost (par value) constitutes taxable income to him, as the respondent has determined, depends upon whether his right to purchase the shares at a bargain price was given to him as compensation for his services. If it was the intention of the parties that that advantage was given to him as additional compensation then the respondent's determination is correct. See Commissioner v. Smith, 324 U. S. 177 (45-1 USTC 9187); Connolly's Estate v. Commissioner, 135 Fed. (2d) 64 (43-1 USTC 9366); Mason v. Commissioner, 125 Fed. (2d) 540 (42-1 USTC 9217); Crowell v. Commissioner, 62 Fed. (2d) 51 (3 USTC 1005). However, if petitioner's right to the bargain purchase of the shares was not acquired by him as additional compensation then the purchase of the shares did not result in realization of taxable income. Delbert B. Geeseman, 38 B.T.A. 258; Herbert H. Springford, 41 B.T.A. 1001.

Amended Regulation

With this background we come to the Treasury releases of April 12, 1946. The regulation previously quoted was amended on that date to read as follows[9]:

> If property is transferred by an employer to an employee for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value *is in the nature of compensation and shall be included in the gross income of the employee.* (Italics supplied.)

In other words, under the amended regulation it is immaterial whether or not there was an intention to compensate the employee; the difference is in every case taxable. The regulation seems entirely unjustified and can certainly find no basis in the *Smith* decision. Taken literally, under the new regulation, an employee might realize taxable income if he buys a dozen golf balls from his employer at the wholesale price.

However, the Treasury cannot create income by regulation. The validity of the regulation will be challenged in the Courts and it would be surprising if the Courts did not find it too sweeping. Nevertheless, taxpayers are now on notice that if stock options are granted to employees they are faced with litigation.

Though, in the writer's view, the amended regulation is in no way supported by the *Smith* decision, the Treasury Decision provides that the amendment to the regulation shall not apply in the case of

[9]Reg. 111, Sec. 29.22(a)-1, as amended by T.D. 5507.

property transferred by an employer to an employee pursuant to the exercise of an option granted to the employee before February 26, 1945 (the *Smith* case having been decided by the Supreme Court on February 25, 1945). There are a number of cases in which the Directors of a corporation authorized options to employees before February 25, 1945 subject to stockholders' approval, and the stockholders' meeting was held after February 25, 1945. In the opinion of the writer, in such cases the options were granted prior to February 26, 1945 within the meaning of the Treasury Decision, though the Treasury has not announced its position on this question.

Treasury Ruling

The Treasury Decision amending the regulations was accompanied by a ruling[10] containing more detailed provisions. With respect to options granted on or after February 26, 1945, a summary of the principal provisions follows:

1. If an employee receives an option to purchase stock of the employer corporation or an affiliate and exercises such option he realizes compensation income to the extent of the difference between the fair market value of the stock and the price paid therefor. There is an implication here that the Treasury will not attempt to tax the employee at the time the option is received.

2. If the employee transfers the option for consideration in an arms-length transaction, the consideration constitutes compensation income when received.

3. If the employee transfers such option in other than an arms-length transaction (e.g. by gift) and the transferee exercises the option, the employee realizes compensation income on the date when the transferee receives the stock to the extent of the difference between the value of the stock at that time and the purchase price.

4. The amount of compensation realized by the employee is deductible by the employer corporation in the year in which the employee is taxable to the extent that it does not exceed reasonable compensation for services.

Options Granted Before February 26, 1945

Where the option was granted prior to February 26, 1945, the ruling contains provisions as reasonable as the amended regulation is unreasonable. In such cases the ruling provides that the employee does not realize compensation income from the exercise or transfer of the option unless at the time the option was granted there was a substantial difference between the fair market value of the stock and

(*Continued on page 22*)

[10] I.T. 3795, I.R.B. 1946-8-12295.

Hands Across the Sea

On the occasion of the Flower Fair at the Fairchild Tropical Garden (which was an enormous success) Mrs. Montgomery thought it would be nice to name a new orchid for Mrs. Winston Churchill, who, when approached, expressed appreciation and gratitude. In conversations and a letter to Mrs. Montgomery, Mrs. Churchill repeatedly referred to her enjoyment of what she called a great honor.

Mrs. Montgomery also thought our place (Elanar) would have several very good places for Mr. Churchill to paint. Using a word I don't like she contacted Col. Clarke, the Churchills's host, whom Mrs. Montgomery knows quite well. The idea was deemed to be good and Mr. Churchill did turn up at our place one afternoon. Alas, we were at Palm Beach. Mr. Churchill after spending about two hours looking for good spots to paint left word that he would return the next day. Another "alas"—the next day it rained! Before they left we met them again. Mr. Churchill said "I was sorry not to get down to your place again—you know it rained." We certainly did know it rained!

ROBERT H. MONTGOMERY.

Rehabilitating Internal Controls

(*Continued from page 14*)

Thus the present general state of health of internal accounting control should be considered by both comptroller and certified public accountant as a significant condition which may require examination and treatment at the earliest opportunity. It must be placed high on the list of essential accounting tasks in the period of reconversion and rehabilitation through which we are now passing. Just as plant engineers have been busying themselves with plant clearance and production men are retooling for normal manufacture, so should the accounting executive, with the help of his consultants, clear out emergency accounting and auditing methods which may have been necessary in wartime and replace them with efficient modern tools adapted to controlling the normal operations of peacetime industry.

The L. R. B. & M. Journal

Published by Lybrand, Ross Bros. & Montgomery, for free distribution to members and employees of the firm.

The purpose of this journal is to communicate to every member of the staff and office plans and accomplishments of the firm: to provide a medium for the exchange of suggestions and ideas for improvement; to encourage and maintain a proper spirit of cooperation and interest, and to help in the solution of common problems.

Internal Control

The article by Mr. Perry on "Rehabilitating Internal Controls" deals with a subject which is of major importance to public accountants and their clients. As auditors, the extent of the work which we do in order to enable us to express an opinion with respect to a company's financial statements is determined to a considerable degree by the adequacy and effectiveness of the system of internal check and control. From the client's standpoint, adequate internal control serves to assure more accurate recording of financial transactions, providing reliable data for management purposes, as well as minimiz-

ing the possibilities of large-scale defalcations and misappropriation of funds.

As Mr. Perry points out, the tremendous volume of business, the demand for speed, the changes in personnel, etc., experienced during the war years tended to a relaxing of controls, and it is highly desirable that attention be given to strengthening the weak spots as soon as possible. Accountants are in a position to render a valuable service to their clients by bringing to their attention existing weaknesses and offering suggestions for their correction.

Income Tax Aspects of Stock Options

(*Continued from page 19*)

the option price or unless the employee would otherwise clearly realize compensation income under the regulation prior to its amendment. The employee and the employer corporation must, on or before July 1, 1946, file in duplicate with the Commissioner written consents agreeing (1) that the tax basis of the stock in the hands of the employee or any transferee shall be the actual purchase price, and that neither the employer or employee shall claim any deduction or loss with respect to any aspect of the option arrangement and (2) indemnifying the Commissioner against the filing of any claims or any other action inconsistent with the consents filed.

The ruling further states that in determining what constitutes a substantial difference between the fair market value of the stock and the option price consideration will be given among other things to the number of shares subject to the option, to the previous variations in fair market value of the stock, and to the type of business and history of the employer corporation and its affiliates.

It would generally seem desirable to secure a ruling from the Commissioner on the facts in a particular case before exercising the option.

Notes

Mr. Sinclair was elected Presidebt of the New York State Society of Certified Public Accountants for the fiscal year 1946-1947 at the annual meeting of the Society held on May 13, 1946. Mr. Sinclair is serving as First Vice-President during the current fiscal year.

Detroit Office

Mr. Edwin P. Noell, who has been a member of our organization for many years, first in New York and later in Cleveland, is now associated with the Detroit office, assisting the partners, Mr. Russell and Mr. McCullough.

During the war Mr. Noell first served with the War Shipping Administration on a special assignment and then with the Navy Department, being a Lieutenant Commander at the time of his recent release from service.

The Philadelphia office has recently published a booklet entitled "State Taxation of Corporations in Pennsylvania." The Pennsylvania domestic and foreign bonus, the capital stock tax, franchise tax, corporate net income tax and corporate loans tax are outlined at some length; other taxes are also covered, but more briefly, because of their limited application to corporations. The outline was prepared by Mr. James J. Mahon, Jr., of the Philadelphia office tax department.

Shortly after publication of the January issue of the JOURNAL an officer of one of New York's largest banks phoned us to inquire whether we could make available to him a number of extra copies of the issue. As instructor for a class in the American Institute of Banking, he desired to use the article on "The Significance of the Balance Sheet—What is Book Value?" as text material in the study of problems related to the analysis and interpretation of financial statements. We were, of course, pleased to fulfill his request.

The Machinery Institute, of Washington, D. C., also was supplied with a number of copies for distribution to members.

Quarter Century Club

The members of the Quarter Century Club of the New York office recently met for dinner and an evening of good fellowship.

At the present time, the Club has nine members, facetiously referred to as "the nine old men." Seven were present at the dinner.

The very cordial spirit prevailing at the dinner was enhanced a great deal by a number of excellent stories by Ralph Grover and Rudy Flachbart.

The Club plans to hold another dinner at which members' wives will also be present, followed by a theatre party or some other diversion, and it is hoped that twenty-five-year members of other offices will join in the festivities.

Mr. Walter G. Draewell, of our San Francisco staff, read a paper on the subject "Internal Check" at the January meeting of the San Francisco Chapter of the California Society of Certified Public Accountants.

Mr. Arno R. Kassander, of our New York staff, addressed the Brooklyn Chapter of the National Association of Cost Accountants on January 16th on the subject "Types of Industries to which Standard Costs are Applicable and Why."

An article prepared by Mr. Raymond G. Ankers, of our New York staff, on the subject "The Question of Staff Training," appeared in the January issue of *The Accounting Review*.

The annual meeting of the American Institute of Accountants is to be held in New York next September in conjunction with the New York State Society's celebration of the 50th anniversary of the enactment of the first C.P.A. law in this country. The two organizations have appointed identical committees on meetings and on technical sessions, Mr. Sinclair being a member of the technical sessions committee, and Mr. Jennings of the meetings committee.

The January issue of the JOURNAL contained a list of committees of the American Institute of Accountants on which various of our partners are serving during the present year. Additional Institute committee appointments include the following partners and staff members:

Mr. Sinclair
  Committee on Cooperation with Stock Exchanges
Mr. Sweet
  Committee on Cooperation with SEC
Mr. Keast
  Committee on Cooperation with Bankers and Other Credit Grantors
Mr. Lenhart
  Committee on Accountants' Liability and Liability Insurance (Chairman)
Mr. Richardson
  Committee on Publication
Mr. R. G. Ankers
  Committee on Education (3 year term)
Mr. A. R. Kassander
  Committee on Accounting Machinery

Mr. Perry is serving as a member of the Board of Examiners of the American Institute of Accountants.

Messrs. Fred P. Albrecht, Frank S. Baker and Edward W. Bowen, of our Chicago staff, have passed the Illinois C.P.A. examinations.

Mr. John D. Barnes, of our Atlanta staff, has passed the Georgia C.P.A. examinations.

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